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No. 1202

In the Supreme Court of the United States

OCTOBER TERM, 1978

VINCENT F. CHIARELLA, Petitioner
v.
UNITED STATES OF AMERICA, Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION FOR LEAVE TO FILE MEMORANDUM AMICUS CURIAE and MEMORANDUM AMICUS CURIAE OF THE SECURITIES INDUSTRY ASSOCIATION

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MOTION FOR LEAVE TO FILE MEMORANDUM AMICUS CURIAE

Pursuant to Rule 42(3) of this Court's Rules, the Securities Industry Association (the "Association") respectfully moves the Court for leave to file the attached Memorandum *amicus curiae*. The petitioner, Vincent F. Chiarella, has declined to consent to the filing of such a memorandum; the respondent, United States of America, has consented.

The Association is comprised of approximately 500 brokers and dealers in securities, who transact business throughout the United States and the free world. Its members service securities investors of every size and type, and perform a complete spectrum of professional securities activities. The Association is generally recognized as a spokesman for the securities industry.

The decision below articulates a novel theory of liability under Section 10(b) of the Securities Exchange Act of 1934,* and Rule 10b-5 thereunder,** that could be in appro-

* 15 U.S.C. §78j(b).

** 17 CFR §240.10b-5 (1978).

priately applied in the future to the normal and beneficial trading activities of securities brokers and dealers. Although Rule 10b-5 liability may, under appropriate circumstances, be applied to abuses of market information, the failure of the court below to consider the potential ramifications of its broadly-defined test of liability could upset careful statutory and regulatory approaches to complex market functions.

Leave of this Court is sought to offer the Association's different perspective on the proper resolution of the important liability questions the parties have raised, so that the decision in this case can most effectively be reconciled with the legislative history, structure, and purposes of the Securities Exchange Act.

For the foregoing reasons, the Association should be permitted to file the attached Memorandum *amicus curiae*.

Respectfully submitted,

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MEMORANDUM OF THE SECURITIES INDUSTRY ASSOCIATION, AMICUS CURIAE

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34)* is reported at 588 F.2d 355. The opinion of the district court (Pet. App. B1-B3) is reported at 450 F.Supp. 95.

JURISDICTION

The judgment of the court of appeals was entered on November 29, 1978. A timely petition for rehearing, and a suggestion that such rehearing be held *en banc*, were denied on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979, and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. §1254(1).

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* References to the Appendix filed in this Court with the Petition for a Writ of Certiorari are cited as "Pet. App. ____"

STATUTE AND RULE INVOLVED

The decision below raises "novel" questions of first impression, articulated in a criminal proceeding, concerning the scope and application of Section 10(b) of the Securities Exchange Act of 1934 (the "Securities Exchange Act" or the "Act")* and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission (the "SEC" or the "Commission").**

QUESTION ADDRESSED

Given that, in the course of their normal securities trading activities, securities dealers regularly receive "market information," uses of which are subject to a statutory and regulatory scheme applicable to such dealers' trading activities, did Congress intend, as the court below suggested, that the "'catchall'"*** antifraud provision of Rule 10b-5 should be utilized to impose upon securities dealers an expanded prohibition against the conduct of their normal securities trading activities while in the possession of material, nonpublic, market information?****

STATEMENT

1. The petitioner, Vincent F. Chiarella, seeks the reversal of the decision of the court of appeals which affirmed his conviction, after a jury trial, for violations of Sections

* 15 U.S.C. §78j(b).

** 17 CFR §240.10b-5 (1978).

*** *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202, *rehearing denied*, 425 U.S. 986 (1976). *Cf. International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. ___, 99 S. Ct. 790, 801-802 (1979).

**** The Securities Industry Association limits the expression of its views to the issue specified in the text.

10(b) and 32(a)* of the Securities Exchange Act, and Rule 10b-5 thereunder. The petitioner was employed by a financial printer as a "markup man" (Pet. App. A3); in that capacity, he regularly received, among other things, early drafts of forms promulgated by the SEC to require the public disclosure of tender offers for the control of the stock of publicly-held companies (Pet. App. A3-A4).

In this case, the petitioner is alleged to have deciphered the identities of several prospective tender offer targets, (despite efforts to keep that information confidential) and, thereafter, to have engaged in a series of transactions in each target company's stock, buying immediately before, and selling shortly after, the announcement of the tender offer (Pet. App. A2, A4). In all, the petitioner engaged in some seventeen securities transactions, involving five separate tender offers, for a profit of more than $30,000 (Pet. App. A3-A5).

2. The petitioner was indicted on seventeen separate counts—representing each transaction—of the willful misuse of material, nonpublic information in connection with the purchase and sale of securities (*id.*). Specifically, the petitioner was indicted for his use of the nonpublic information about impending tender offers, *coupled with* his failure to disclose that information prior to his purchases of target companies' securities.

Following the indictment, the district court heard, and subsequently denied, the petitioner's motion to dismiss. Despite the Government's concession that this case involved "a novel application of §10(b)" (Pet. App. B1-B2), the district court concluded that the petitioner's "alleged misuse of information . . . falls within the intent of Congress in the enactment of §10(b) . . ." (Pet. App. B3).

3. After a trial that resulted in a jury verdict of conviction on all seventeen counts, the petitioner appealed on the

* 15 U.S.C. §78ff(a).

ground that, since he was not an insider of any of the target companies whose securities he purchased, he did not owe any fiduciary duty to target company shareholders who sold their stock before the various tender offers were publicly announced. As a result, he urged that he was free to trade on the information in question without that trading constituting a violation of Rule 10b-5 (Pet. App. A6). The petitioner also raised a number of additional grounds for the reversal of his conviction, involving issues of due process, standards of culpability and procedural error (Pet. App. A18-A23). The court of appeals rejected these contentions and affirmed the conviction by a divided vote.*

The court below broadly perceived Section 10(b) of the Securities Exchange Act as a provision designed to prohibit "conduct that destroy[s] confidence in the securities markets," and to forbid "'those manipulative and deceptive practices which have been demonstrated to fulfill no useful function'" (Pet. App. A14-A15). The court found it "irrelevant" (Pet. App. A6) that no prior adjudicated decision of any court had held someone in Mr. Chiarella's position liable —civilly or criminally—under Rule 10b-5.

Rather, the court below focused on the "strategic places in the market mechanism" occupied by financial printers (Pet. App. A7), and held that such persons must "be forbidden to reap personal gains from information received by virtue of their position" (*id.*). The court of appeals apparently rejected (Pet. App. A8 n.8) any meaningful distinction between *inside* corporate information (that is, information which emanates from *within* a corporation and relates directly to that corporation or its activities) and so-called "*market* information" (that is, information which emanates from *outside* the corporation and relates to the *market* for

* Chief Judge Kaufman wrote the majority opinion, joined by Circuit Judge Smith. Circuit Judge Meskill dissented in a separate opinion.

the corporation's stock*); instead, the court held (Pet. App. A7) that "'all investors trading on impersonal exchanges [should] have relatively equal access to material information.'"

In this context, the court below opined that its newly-established class of "*market* insiders"—persons who regularly receive nonpublic, outside, information concerning publicly-held corporations—may be liable to the same extent as *corporate* insiders (Pet. App. A7-A9). And, using the broad language that is the focus of this brief, the court below stated:

> "*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."

Pet. App. A8 (emphasis in original, footnote omitted).**

THE INTEREST OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association (the "Association") is comprised of approximately 500 brokers and dealers in securities, who transact business throughout the United

* Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 799 (1973); *In re Oppenheimer & Co.*, [1975-1976 Decisions] CCH Fed. Sec. L. Rep. ¶80,551 (SEC, Apr. 2, 1976).

** Despite the breadth of this statement, the court below cautioned (Pet. App. A10) that it should "not . . . be understood as holding that no one may trade on nonpublic information without incurring a duty to disclose." The court failed, however, to articulate precisely who might be able to "trade on nonpublic information without incurring a duty to disclose," although it did hold that prospective tender offerors are *not* "market insiders" and therefore do not owe a fiduciary duty to the securities marketplace (Pet. App. A10-A11).

States and the free world. Its membership is responsible for over 90 percent of the securities brokerage business conducted in this Country, and includes members of every national securities exchange, as well as securities firms that are not members of any exchanges.

The Association's members service securities investors of every size and type, and perform a complete spectrum of professional securities activities, including retail and institutional brokerage, over-the-counter market making, underwriting and other investment banking activities, various exchange floor functions, and money management and investment advisory services. As a consequence, the Association is generally recognized as a spokesman for the securities industry.

Because the test of Rule 10b-5 liability enunciated by the court below was overly-broad, and could be inappropriately applied in the future to normal and beneficial trading activities of securities brokers and dealers, the Association respectfully submits this memorandum, *amicus curiae*.

SUMMARY OF DISCUSSION

As this Court has recently reiterated, a "key part" of the Congress' program of economic recovery after the stock market crash in 1929 was not only the "[p]revention of frauds against investors . . . , but [also] . . . the effort 'to achieve a high standard of business ethics . . . *in every facet of the securities industry.*'"* In that context, Congress sought not simply to regulate securities dealers, but to do so in a manner most calculated to assure the viability of the

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* *United States* v. *Naftalin*, 441 U.S. ——, ——, 47 U.S.L.W. 4574, 4576 (May 21, 1979) (emphasis in original), quoting *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-187 (1963).

securities markets as an integral part of the capital-raising function so necessary to a free economy.*

Recognizing the complexity of the securities marketplace, and the need for clarity in defining the proper role of market professionals, the Congress expressly delineated the generic standards to which it believed securities dealers should adhere, bestowing direct rulemaking authority on the Securities and Exchange Commission to fill in the interstices of the statutory scheme, within appropriately circumscribed parameters. The Association's members are thus part of a securities industry that is highly regulated. Rules promulgated by the SEC span nearly 1,000 pages of Volume 17 of the Code of Federal Regulations, and the steady stream of daily interpretations, opinions, releases, and reports promulgated by the Commission consumes thousands of additional pages of fine type each year.

Moreover, in order to place most of the emphasis for the development of ethical standards where it properly belongs—on the securities industry itself—the Congress in 1934 also established a unique statutory pattern of supervised self-regulation of the securities industry,** a statutory pattern only recently reaffirmed and expanded.*** This sys-

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* *United States* v. *Naftalin*, *supra*, 441 U.S. at ——, 47 U.S.L.W. at 4576; *accord*, *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659, 689 (1975). *And see* Section 11A(a)(1)(A) of the Securities Exchange Act, 15 U.S.C. §78k-1(a)(1)(A) ("The Congress finds that . . . [t]he securities markets are an important national asset which must be preserved and strengthened").

** *Silver* v. *New York Stock Exchange, Inc.*, 373 U.S. 341, 349-356 (1963); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117, 127-128 (1973); *Gordon* v. *New York Stock Exchange, Inc.*, *supra*, 422 U.S. at 667, 681.

*** *See* P. L. 94-29, 94th Cong., 1st Sess. (Jun. 4, 1975); H. R. Rep. No. 94-123, 94th Cong., 1st Sess. 91 (Apr. 7, 1975); H. R. Rep. No. 94-229, 94th Cong., 1st Sess. 44, 48-49 (May 19, 1975); S. Rep. No. 94-75, 94th Cong., 1st Sess. 22-23 (Apr. 14, 1975).

tem of supervised self-regulation accounts for the promulgation of extensive, additional, regulations applicable to the securities trading activities of the Association's members.*

The decision below jeopardizes this carefully constructed statutory scheme of direct, as well as self, regulation. It suggests that securities dealers, who of necessity must, and constantly do, have access to undisclosed "market" information, may *automatically* be disabled from their normal and beneficial trading activities. To that extent, by utilizing such a diffuse test of Rule 10b-5 liability,** the court of appeals has, unnecessarily and detrimentally, " 'manufacture[d] ambiguity where none exists.' "***

The development of standards of conduct applicable to market trading by such professionals should continue to be primarily the result of rulemaking by the SEC and the securities industry self-regulators, since rules of that nature, unlike *ad hoc* adjudications under generic antifraud provisions, are subject to appropriate procedural safeguards, and can be carefully tailored to take account of market complexities.

Although Rule 10b-5 properly may be applicable to the abuse of so-called "market" information, such an application

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* *See, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 847-860; *accord*, Subcommittees of American Bar Association Section of Corporation, Banking, and Business Law, *Comment Letter on Material, Non-Public Information* (Oct. 15, 1973) reprinted in BNA, *Securities Regulation & Law Report*, No. 233 (Jan. 2, 1974), pp. D-1 through D-7 (hereinafter "American Bar Association Comment Letter").

** *See Securities and Exchange Commission* v. *National Securities Inc.*, 393 U.S. 453, 465 (1969).

*** *United States* v. *Naftalin*, *supra*, 441 U.S. at ——, 47 U.S.L.W. at 4577, quoting *United States* v. *Culbert*, 435 U.S. 371, 379 (1978).

of the Rule should rest (as it traditionally has) on more precisely drawn grounds than were articulated by the court below. As this Court has previously suggested, the mere status of an individual as a "market insider" is not, without more, generally sufficient to warrant the imposition of liability under Rule 10b-5.* Moreover, "not every failure to disclose material information constitutes a violation of the anti-fraud rules."**

There is little doubt, of course, that, where any person (market professional or otherwise) possesses material, nonpublic, market information and makes *affirmative* misrepresentations about that information to a purchaser or seller of securities in connection with a securities transaction, Rule 10b-5 liability could properly be invoked.*** And, at least in some circumstances, where a person in possession of material, nonpublic, market information affirmatively *induces* specific purchases or sales of securities without disclosing that information, Rule 10b-5 liability has also been deemed appropriate.****

But, in the absence of either of these circumstances, the imposition of Rule 10b-5 liability for the mere failure to

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* *See Affiliated Ute Citizens of the State of Utah* v. *United States*, 406 U.S. 128, 152, *rehearing denied*, 408 U.S. 931 (1972) ("[w]e would agree that if the [defendant] had functioned merely as a transfer agent, there would have been no duty of disclosure here"); *accord, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804: "The duty to disclose material, non-public information has not been imposed on every person possessing this type of information."

** American Bar Association Comment Letter, *supra*, at p. D-6.

*** *See, e.g.*, Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 802 & n.18.

**** *Affiliated Ute Citizens of the State of Utah* v. *United States*, *supra*, 406 U.S. at 153.

disclose material, nonpublic, market information should be limited to situations involving either

> (i) a deliberate breach of a duty to disclose such information pursuant to a clear and statutorily-articulated fiduciary relationship owed to the purchaser (or seller) of securities;* or
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> (ii) the deliberate utilization of such information for purely personal purposes, in circumstances where the information was received solely by virtue, and in furtherance, of a confidential business relationship, where there is a clear showing "that an expectation of fair dealing . . . is justified."**

To the extent the decision of the court below implies any broader extension of Rule 10b-5 liability to cover normal trading activities of securities dealers, it is without either precedent or logic.

DISCUSSION

THE STANDARD OF RULE 10b-5 LIABILITY ARTICULATED BY THE COURT BELOW IS OVERLY-BROAD AND, AS A RESULT, COULD ADVERSELY AFFECT THE TRADING ACTIVITIES OF MARKET PROFESSIONALS.

A. The Court of Appeals Inappropriately Embraced a Broad Standard of Rule 10b-5 Liability Without Considering the Comprehensive Provisions in the Securities Exchange Act for the Regulation of the Trading Activities of Securities Dealers.

Prior to the decision below, the "disclose-or-abstain" rule it enunciates for those in possession of material, nonpublic,

* *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6; *and see, Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462, 479 (1977); *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. 180; *cf. Burks* v. *Lasker*, 441 U.S. ____, 99 S. Ct. 1831, 1835-1839 (1979).

** Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 821-822.

information had not been universally applied. Indeed, traditionally, that obligation had been limited to persons with a special relationship to the company affected by the information—so-called "corporate insiders," or their tippees, who possessed inside, corporate, information.*

But, the decision of the court below can be read as effectively eviscerating any practical distinction, under Rule 10b-5, between *inside* corporate information—the traditional subject of most Government and private actions under Rule 10b-5—and *outside* market information. Such a reading of the decision could create serious and unwarranted confusion concerning the obligations of securities dealers, not to mention their exposure to potential civil liability, for normal and beneficial trading activities.

As both the SEC and Congress have noted on several occasions, however, the effectiveness of the securities market is, in important respects, dependent not only upon the participation of public investors, but also upon securities dealers, such as "[s]pecialists, block positioners and floor

* *See, e.g., In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (SEC, 1961); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (C.A. 2, 1968) (*en banc*), *certiorari denied, sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976 (1969); *In re Investors Management Co.*, Securities Exchange Act Release No. 9267, [1970-1971 Decisions] CCH Fed. Sec. L. Rep. ¶78,163 (SEC, Jul. 29, 1971); Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804; American Bar Association Comment Letter, *supra*, at p. D-1.

traders* [who] also contribute to the public nature of securities markets by risking their capital to absorb imbalances

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* A "specialist" is a member of a national stock exchange charged with the responsibility of maintaining a fair and orderly market in those stocks assigned to it. Among other things, a specialist may be required to effect purchases and sales of securities on its own behalf in order to minimize temporary disparities between supply and demand. Specialists also receive and hold "limit orders"—that is, orders to buy or sell a stock when the market ultimately reaches a specified price. *See* 2 Securities and Exchange Commission, *Report of the Special Study of Securities Markets*, H. R. Doc. No. 95, 88th Cong., 1st Sess. 47 (1963) (hereinafter *"Special Study"*).

A "block positioner" is a broker-dealer in securities that facilitates the purchase and sale of large quantities of various securities, often by committing its own capital to buy a portion of the total number of securities involved. *See* Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 *Fed. Reg.* 6084, 6088-6089 (Jan. 31, 1979). Although there is no consistently-applied definition of the term, a "block" of stock generally signifies at least 10,000 shares, or a quantity of stock with a current value of at least $200,000. *Id.*, 44 *Fed. Reg.* at 6089 n.45.

A "floor trader" is a registered member of a national securities exchange that regularly effects transactions for its own account on the exchange floor. *See* 2 *Special Study, supra,* at 47.

Other securities dealers include: over-the-counter market makers, dealers responsible for maintaining a continuous marketplace for securities in the non-exchange market; odd-lot dealers, exchange members that specialize in facilitating transactions in units of less than 100 shares; *bona fide* arbitrageurs, securities dealers that regularly effect proprietary trades seeking to obtain a profit from the disparity in prices available in two markets for a security and its equivalent; and risk arbitrageurs, securities dealers that regularly effect proprietary trades in a security that is, or may be, the subject of a tender offer, or other corporate reorganization, with a view toward the eventual tender or sale of such a security. *See* Securities Exchange Act Release No. 15533, *supra,* 44 *Fed. Reg.* at 6089-6090.

in supply and demand."* Indeed, the Commission has labeled as "necessary" the functions performed by these dealers in order to "increase the depth, liquidity and orderliness of trading markets, enabling investors to implement trading decisions with relative ease and confidence."**

Because of their central position in the securities trading markets, market professionals often engage in securities transactions while possessing valuable nonpublic information relating, for example, to the (i) volume and type of order flow in a particular security; (ii) existing bids and offers on a specialist's "book";*** (iii) inventory of a block positioner, particularly blocks of stock that are to be "liquidated" or "laid off"; (iv) positions of arbitrageurs and risk arbitrageurs; and (v) institutional interest in the

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* *See, e.g.,* Adoption of Securities Exchange Act Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes, Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 *Fed. Reg.* 3902, 3918 (Feb. 8, 1973). *Accord, e.g.,* Securities Transactions by Members of National Securities Exchanges, Securities Exchange Act Release No. 15533, *supra,* 44 *Fed. Reg.,* at 6088-6091; S. Rep. No. 94-75, *supra,* at 68, 99; H. R. Rep. No. 94-123, *supra,* at 57, 72.

** Securities Exchange Act Release No. 9950, *supra,* 38 *Fed. Reg.* at 3918; *accord,* 8 Securities and Exchange Commission, *Institutional Investor Study Report,* H. R. Doc. No. 92-64, 92d Cong., 1st Sess. xxii (1971) (hereinafter *"Institutional Investor Study Report"*).

*** A specialist's "book" is a book in which he enters, as a broker, limited price orders he has received from others to purchase or sell a specific security, at a specific price that is either higher or lower than the existing market in that security, for execution at a later time when the market moves to the price designated in such orders. The information in a specialist's book has an "importance beyond that of a mere repository of unexecuted agency orders. It serves as the indicator of public interest in a particular security." 2 *Special Study, supra,* at 76.

purchase or sale of blocks of stock.* Such information may, under many circumstances, be nonpublic, material, "market" information. In light of the decision of the court below, however, there is now some possibility that trades effected by securities dealers while in the possession of such information might be deemed to violate Rule 10b-5.

But, as the SEC only recently reiterated, the Securities Exchange Act and its legislative history contemplate the frequent access of market professionals to this valuable information:

> "Traditionally, market professionals have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the continuity, liquidity and depth of the markets for those securities." **

To that end, the Securities Exchange Act vests in the Commission and the various securities industry self-regulators direct regulatory authority to reconcile the possession by

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* *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6.

** Securities and Exchange Commission, *Report of the Special Study of the Options Markets*, H. R. Comm. Print No. 96-IFC3, 96th Cong., 1st Sess. 1-4 (1978) (hereinafter "*Options Study*"); *accord*, 2 *Special Study*, *supra*, at 76-83, 90, 127-128, 135, 203-242; *In re Albert Fried & Co. and Albert Fried, Jr.*, Securities Exchange Act Release No. 15293 (Nov. 3, 1978), 16 *SEC Docket* 100, 104 (SEC, Nov. 21, 1978) (The "*quid pro quo*" for conferring advantages on specialists, and other securities dealers "has been the imposition of regulation to assure that in trading for his own account he uses those privileges for the benefit of the market generally . . ."); American Bar Association Comment Letter, *supra*, at p. D-6 ("The policy in this area has been to regulate the performance of these professionals' functions rather than to eliminate their informational advantage deriving from their very function in the marketplace and thereby to deny to the public their contribution to the functioning of the market mechanism.").

securities dealers of valuable nonpublic trading information with the express goal of the Act "to insure the maintenance of fair and honest [securities] markets. . . ."*

Thus, for example, in Section 11(a) of the Act, as originally adopted,** the SEC was empowered to regulate "trading by [stock exchange] members for their own account, whether on or off the floor of the exchanges. . . ."*** Similarly, Section 11(b) of the Act, as originally enacted,**** authorized the various stock exchanges to adopt rules permitting "the registration of members as odd-lot dealers or specialists, or both,***** and authorizing these members to trade "for their own account as may be reasonably necessary to permit them to maintain a fair and

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* Section 2 of the Securities Exchange Act as originally passed, P. L. No. 291, 73d Cong., 2d Sess. §2 (Jun. 6, 1934).

** P. L. No. 291, *supra*, §11(a); *and see*, S. Rep. No. 1455, 73d Cong., 2d Sess. 29 (Jun. 6, 1934).

*** S. Rep. No. 1455, *supra*, at 29.

In 1975, Section 11(a) of the Act was significantly amended (P. L. 94-29, *supra*, §6) in light of the Congress' recognition of the "informational and market proximity advantages" of securities dealers who are privy to nonpublic, "market" information. H. R. Rep. No. 94-123, *supra*, at 54-55. In expanding the potential coverage of a ban on exchange members trading for their own accounts, however, the Congress exempted transactions by securities dealers, which were "deemed either to be beneficial to the markets or not to pose so great a danger to the fair and orderly functioning of the markets. . . ." S. Rep. No. 94-75, *supra*, at 68. Those categories include transactions by specialists, market makers, block positioners, registered odd-lot dealers, *bona fide* arbitrageurs, and risk arbitrageurs. *See* Sections 11(a)(1)(A)-(D), 15 U.S.C §§78k(a)(1)(A)-(D).

**** P.L. No. 291, *supra*, §11(b).

***** S. Rep. No. 1455, *supra*, at 29-30.

orderly market."* Significantly, although the statute contemplated that specialists could and would trade for their own accounts, under Section 11(b) specialists expressly were, and today still are, generally "forbidden to reveal information in respect to orders placed with them. . . ." **

To similar effect are the regulations adopted by the various securities industry self-regulators, pursuant to Sections 6(b)(5) and 15A(b)(8) of the Act,*** to govern the conduct, trading activities and related disclosure obligations of their constituent-member securities dealers.**** While

* *Id.*, at 30. Section 11(b) was amended in 1975 (P.L. No. 94-29, *supra*, §6) to delete the restriction in the original statute that permitted members' trading for their own accounts only to the extent necessary for the maintenance of a fair and orderly market. The change was explained as appropriate "to provide . . . greater flexibility in prescribing a specialist's obligations in a national market system." *See* S. Rep. No. 94-75, *supra*, at 100.

** S. Rep. No. 1455, *supra*, at 30. As can readily be observed, however, the "disclose-or-abstain" test of Rule 10b-5 liability proffered by the court below, if applied literally to securities dealers, would thus conflict with a specialist's statutory obligations under Section 11(b) of the Act.

*** 15 U.S.C. §§78f(b)(5) and 78*o*-3(b)(8). These sections require the stock exchanges and the National Association of Securities Dealers, Inc., respectively, to adopt rules designed, among other things, "to promote just and equitable principles of trade."

**** For example, the rules of the various exchanges establish trading requirements for specialists, who, as we have seen, are given informational advantages so that they may "assist in the maintenance, so far as practicable, of a fair and orderly market." Securities Exchange Act Rule 11b-1(a)(2)(ii), 17 CFR §240.11b-1(a)(2)(ii)(1978); *accord*, New York Stock Exchange ("NYSE") Rule 104.10, 2 CCH *NYSE Guide* ¶2104.10; American Stock Exchange ("ASE") Rule 170(b), 2 CCH *ASE Guide* ¶9310. *And see, e.g.*, NYSE Rules 104.10(5), 104.10(6), 104.11, 2 CCH *NYSE Guide* ¶¶2104.10, 2104.11 (specialist's interest in pools and options); NYSE Rule 113, 2 CCH *NYSE Guide* ¶2113 (prohibitions relating to pub-

(footnote continued on next page)

many of these rules are rather straightforward, others required the application of highly-refined expertise to assure that, in adopting regulations to govern complex market functions, the resulting rules were consistent with, and continued to foster, the efficient operation of the securities markets. Particularly where questions of market information have been involved, the development of appropriate regulations has required detailed consideration over an extended period of time.*

Numerous other provisions of the Securities Exchange Act, both as originally adopted, and as recently amended in 1975, establish a system for the comprehensive regulation

(footnote continued from preceding page)

lic customers); NYSE Rule 115, 2 CCH *NYSE Guide* ¶2115 (prohibition against the disclosure of specialists' orders). The exchanges also have detailed rules relating to odd-lot dealers, registered floor traders and block positioners. *See, e.g.*, NYSE Rule 90, 2 CCH *NYSE Guide*, ¶2090 (prohibiting certain members' transactions); NYSE Rule 108, 2 CCH *NYSE Guide* ¶2108 (limiting certain members' bids and offers); NYSE Rule 112, 2 CCH *NYSE Guide* ¶¶2112 and 2112(A) (restrictions on floor traders and reports by off-floor traders); NYSE Rule 97, 2 CCH *NYSE Guide* ¶2097 (limitation on members' trading because of block positioning); and NYSE Rule 127, 2 CCH *NYSE Guide* ¶2127 (block positioning rules).

* For example, one such practice, known as "front running," involves trading by an exchange member in a security (or an option for that security) while in the possession of nonpublic information concerning an impending block transaction in the same security. It took several years after the problem was identified for the securities industry self-regulatory organizations to develop a proscription against "front running" that would not impede legitimate trading activities. Securities Exchange Act Release No. 15262 (Oct. 20, 1978), 43 *Fed. Reg.* 52318 (Nov. 9, 1978). *See also Options Study, supra*, at 183-189.

of market professionals as well as the securities markets.* Under these circumstances, the SEC's traditional reliance upon its own rulemaking, and rulemaking by the various securities industry self-regulatory organizations, to regulate the performance of securities dealers, rather than to eliminate their informational advantages,** has " 'assure[d]

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* Thus, for example, Section 15(b)(7) of the Act, 15 U.S.C. §78*o*(b)(7), directs the SEC to establish standards for the qualification of all market professionals; and Section 11A, recently added to the Act, 15 U.S.C. §78k-1, directs the SEC to establish a national market system for trading securities, with particular emphasis on the roles of securities dealers in such a system.

And see, e.g., Securities Exchange Act Sections 6(a) and (b), 15 U.S.C. §§78f(a) and (b) (registration of national securities exchanges); 11A(b), 15 U.S.C. §78k-1(b) (registration and regulation of securities information processors); 11A(c), 15 U.S.C. §78k-1(c) (regulation of the distribution or publication of any information concerning quotations for or transactions in securities); 12(a)-(d), 15 U.S.C. §78*l*(a)-(d) (listing of securities for exchange trading); 12(f), 15 U.S.C. §78*l*(f) (unlisted trading privileges for exchange traded securities); 13(f)-(h), 15 U.S.C. §78m(f)-(h) (institutional trading and portfolio holding disclosures); 13(d), 13(e), 14(d), 14(e), and 14(f), 15 U.S.C. §§78m(d), 78m(e), 78n(d), 78n(e), and 78n(f) (regulation of tender offers and other acquisition programs); 17(a)-(b), 15 U.S.C. §78q(a)-(b) (reporting, disclosure and examination requirements for exchanges, exchange members, brokers, and dealers); 17(d), 15 U.S.C. §78q(d) (coordination of responsibilities of self-regulatory organizations); 17A(b), 15 U.S.C. §78q-1(b) (registration and regulation of clearing agencies); 17A(c), 15 U.S.C. §78q-1(c) (registration and regulation of transfer agents); and 19(a), 15 U.S.C. §78s(a) (registration process for exchanges).

** *See, e.g.*, American Bar Association Comment Letter, *supra*, at p. D-6; Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 846.

fairness and mature consideration of [these] rules of general application.' "*

Unfortunately, the decision below unnecessarily threatens to undermine this careful approach to the activities of securities dealers, but without the advantage of the same exposure to "mature" professional judgments that were made available to the Commission through the notice-and-comment procedures mandated by the Administrative Procedure Act.** In sum, the courts should exercise caution in charting new regulatory waters with Rule 10b-5. Effectively employed, that Rule certainly has an important role to play in preserving the integrity of the trading markets. But, its unduly broad application to the normal trading activities of securities dealers, as suggested by the court below, is inconsistent with the reasoned approach to the regulation of the securities markets Congress contemplated when it enacted the Securities Exchange Act over forty-five years ago.

B. Section 10(b) and Rule 10b-5 Should Not Be Utilized as the Primary Regulator of the Extent to Which Securities Dealers May Trade While in Possession of Outside, Market, Information.

The troublesome potential result of the decision below is not that it would permit securities dealers to be sued under

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* *Chrysler Corp.* v. *Brown*, 441 U.S. ____, 99 S. Ct. 1705, 1718 (1979), quoting *National Labor Relations Board* v. *Wyman-Gordon Co.*, 394 U.S. 759, 764 (1969).

** 5 U.S.C. §553. Pursuant to Section 19(b) of the Securities Exchange Act, as amended in 1975, 15 U.S.C. §78s(b), substantive rule proposals of the securities industry self-regulatory organizations are required to be subjected to notice-and-comment procedures comparable to those applicable to the Government.

Rule 10b-5,* but rather that it "would . . . bring within . . . Rule [10b-5] a wide variety of [market professional] conduct traditionally left to . . ." direct regulation by the SEC and the various securities industry self-regulators. *Cf. Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 478. Thus, "[i]n addition to posing a 'danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5,' . . . this extension of [Rule 10b-5 coverage and liability] would overlap and quite possibly interfere with . . ." the express regulatory scheme devised by Congress to regulate the conduct of market professionals. *Id.,* 430 U.S. at 478-479 (citation omitted).** Neither the legislative history of Section 10(b), nor the policies underlying the adoption and administration of Rule 10b-5, justify such a result here.

At the outset, it should be recognized that, putting Section 10(b) and Rule 10b-5 to one side, Congress subjected fraud by securities dealers to both SEC rulemaking and enforcement litigation pursuant to several specific and well-focused statutory antifraud provisions. In that regard, Section 9(a) of the Securities Exchange Act, 15 U.S.C. §78i(a), delineates the classes of exchange market fraud or manipulation

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* Securities brokers and dealers that breach their professional responsibilities have long been subject to discipline for such breaches pursuant to a variety of provisions under the Securities Exchange Act, including Rule 10b-5. *See, e.g., Hanly* v. *Securities and Exchange Commission,* 415 F.2d 589 (C.A. 2, 1969); *Hughes* v. *Securities and Exchange Commission,* 174 F.2d 969 (C.A. D.C., 1949); *Charles Hughes & Co.* v. *Securities and Exchange Commission,* 139 F.2d 434 (C.A. 2), *certiorari denied,* 321 U.S. 786 (1944).

** *See also Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 210; *Touche Ross & Co.* v. *Redington,* 442 U.S. ——, 47 U.S.L.W. 4732 (Jun. 18, 1979).

Congress intended to proscribe;* even with respect to certain types of potentially-manipulative conduct on such exchanges, however, Congress required that the Commission first define and specify the conduct to be proscribed before market professionals could be subjected to private or Government litigation challenges.**

And, to the extent that Congress desired to preclude market professionals from engaging in an even broader range of "manipulative, deceptive, or other fraudulent device[s] or contrivance[s]" than had been specified in the various other sections of the Act discussed above, the SEC was vested with additional authority in Sections 15(c)(1) and 15(c)(2) of the Act.*** Significantly, however, both of these

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* Section 9(a) proscribes, for example, fictitious purchase or sale transactions (so-called "wash" sales or "matched" orders); manipulations designed artificially to raise or to lower the price of a security; false and misleading statements intended to induce purchases or sales; and the use of so-called "tipster" sheets. *See* S. Rep. No. 792, *supra,* at 17. *And see, Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 207.

** *See, e.g.,* Section 9(a)(6) of the Act, 15 U.S.C. §78i(a)(6), which prohibits various price pegging or stabilizing transactions, but only if such conduct is *expressly* in contravention of specific SEC rules. Senate Committee on Banking and Currency, *Hearings on Stock Exchange Practices,* 73d Cong., 1st Sess. 7736-7737 (1934) (remarks of Mr. Pecora). Pursuant to its authority under Section 9(a)(6), the Commission has adopted a number of complex and detailed rules to govern this type of conduct. *See* Securities Exchange Act Rules 10b-6, 10b-7, and 10b-8, 17 CFR §§240.10b-6, 10b-7, and 10b-8 (1978), adopted in Securities Exchange Act Release No. 5194 (Jul. 5, 1955), 20 *Fed. Reg.* 5076 (Jul. 15, 1955). Since these rules apply to both exchange and over-the-counter securities transactions, *both* Sections 9(a)(6) and 10(b) were relied upon as authority for their adoption. *Id. See Piper* v. *Chris-Craft Indus., Inc.,* 430 U.S. 1, 45-46 (1977).

*** 15 U.S.C. §§78*o*(c)(1) and 78*o*(c)(2). *See also* Sections 15(c)(3), 15(c)(5), and 15(c)(6) of the Act, 15 U.S.C. §§78*o*(c)(3), 78*o*(c)(5), and 78*o*(c)(6).

general market professional antifraud provisions *require* the SEC, "by rules and regulations, [to] define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent," before any liability may be imposed.•

Section 10(b) and Rule 10b-5 stand in sharp contrast to these market professional antifraud provisions. Neither specifically mentions market professionals, and noticeably lacking in both are the safeguards inherent in each of the other antifraud provisions relating to market professionals —either the express statutory specification of the conduct intended to be prohibited, or a directive to the SEC to define precisely the conduct sought to be proscribed.

Although "the intended scope of §10(b) . . . [is *not*] revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation,"•• such legislative history as there is reflects Congress' perception that Section 10(b) was viewed as being of essentially *supplemental* importance in accomplishing the aims of the Act.••• Indeed, Thomas G. Corcoran, a spokesman for the drafters of the Securities Exchange Act,•••• confirmed this view when he "described [Section 10(b)]

• The Commission has adopted 16 specific rules to implement its authority under Sections 15(c)(1) and 15(c)(2). *See* Securities Exchange Act Rules 15c1-1, 15c1-2, 15c1-3, 15c1-4, 15c1-5, 15c1-6, 15c1-7, 15c1-8, 15c1-9, 15c2-1, 15c2-3, 15c2-4, 15c2-5, 15c2-7, 15c2-8, and 15c2-11, 17 CFR §§240.15c1-1, 240.15c1-2, 240.15c1-3, 240.15c1-4, 240.15c1-5, 240.15c1-6, 240.15c1-7, 240.15c1-8, 240.15c1-9, 240.15c2-1, 240.15c2-3, 240.15c2-4, 240.15c2-5, 240.15c2-7, 240.15c2-8, and 240.15c2-11 (1978).

•• *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 202.

••• *See, e.g.,* S. Rep. No. 792, 73d Cong., 2d Sess. 6 (Apr. 17, 1934); H. R. Rep. No. 1383, 73d Cong., 2d Sess. 10-11 (Apr. 27, 1934); House of Representatives Committee on Interstate and Foreign Commerce, *Hearings on H. R. 7852 and H. R. 8720,* 73d Cong., 2d Sess. 115 (1934) (remarks of Thomas G. Corcoran).

•••• *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 202.

rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.' "•

Whatever the precise scope and intent of Section 10(b), "[i]t is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was . . ." to elevate Section 10(b) into the *primary* vehicle by which the conduct of securities dealers should be regulated. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 203. And, particularly in the context of this case, the administrative history of Rule 10b-5 confirms this analysis of Section 10(b).••

For one thing, Rule 10b-5 was adopted specifically for the purpose of addressing a misuse of *inside* corporate information.••• In promulgating the Rule, the SEC thus evidenced no intent to address the inherently more complicated issues raised by the use of market information. And, both the release adopting Rule 10b-5, and the Commission's Annual Report describing it, make clear the Commission's awareness that *separate* antifraud rules already governed fraud by market professionals. As the Commission noted: "The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole. . . ."••••

• *Id.,* 425 U.S. at 203.

•• "It suffices to say . . . that the language of the statute and not the rules must control." *Touche Ross & Co.* v. *Redington, supra,* 442 U.S. at ____ n. 18, 47 U.S.L.W. at 4737 n. 18; *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 214; *Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 472.

••• [T]he president of a corporation was telling the other shareholders that the corporation was doing poorly and purchasing their shares at . . . depressed prices, when in fact the business was doing exceptionally well." *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 212 n. 32.

•••• *See* Securities Exchange Act Release No. 3230 (May 21, 1942) 13 *Fed. Reg.* 8183 (Dec. 22, 1948); Securities and Exchange Commission, *Eighth Annual Report* 10 (1942).

Moreover, the Commission's administration of Section 10(b) and Rule 10b-5 reflects its traditional understanding of the propriety of limiting the role of Rule 10b-5 in cases involving the access of securities dealers to market information.* And, even more recently, in a variety of circumstances involving the conduct of securities dealers and their potential abuses of market information, the Commission has consistently relied on, or recommended the use of, its direct regulatory powers, rather than Section 10(b) and Rule 10b-5.**

* As we have seen, to the extent trading restrictions have been imposed on market professionals, such as specialists and floor traders, these restrictions "have not historically been grounded in the antifraud provisions of the securities laws, but appear to have been developed primarily under the SEC's broad [rulemaking] powers under section 11 of the Exchange Act . . . or by the exchanges under the broad authority to regulate the conduct of their members, including the power to establish 'just and equitable principles of trade.'" Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 846; *accord*, 4 Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs, *Hearings on the Senate Industry Study*, 92d Cong., 2d Sess. 67-68 (1972); American Bar Association Comment Letter, *supra*, at p. D-6. *Cf.* Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N. Y. U. L. Rev. 695 (1973).

** Thus, for example, the Commission recently reported to the Congress on a year-long study of the conduct of market professionals who trade in exchange-listed options contracts. *See Options Study, supra.* Although the Commission there criticized certain alleged abuses of market information, *id.*, at 37-38, 139-153, 178-190, 948-951, and 956-962, the Commission recommended the adoption of specific rules to correct the situation (*id.*, at 188), but did not recommend reliance on either Section 10(b) or Rule 10b-5 for such a purpose. *Accord, e.g.*, 8 *Institutional Investor Study Report, supra*, xxxi-xxxii (use of information about an impending tender offer should *not* be the subject of Rule 10b-5); Securities Exchange Act Release No. 6022 (Feb. 5, 1979), 44 *Fed. Reg.* 9956 (Feb. 15, 1979) (proposal to adopt a specific rule—Rule 14e-2—to circumscribe the trading activities of would-be tender offerors and their allies once a decision to make a tender offer has been formulated).

The reasons militating against the utilization of Rule 10b-5 in such a fashion were best articulated by the SEC itself, in transmitting its *Institutional Investor Study Report* to Congress, in which the agency recommended *against* the use of Rule 10b-5 to deal with a phenomenon known as *warehousing*—a process by which a would-be tender offeror alerts "friendly" institutional investors of an impending tender offer in order to encourage the transfer of the target company's stock into the hands of investors who are likely to be receptive to the proposed tender offer when it is actually made.

In its report, the Commission expressly noted that *"different underlying principles"* from those involved in the misuse of inside information should and do govern the use of market information.* As the Commission stated, such a difference does

> "not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, *this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5* resting on a somewhat different theory than that underlying that rule as to the obligation and duties of those who receive material undisclosed [corporate] information."**

* 8 *Institutional Investor Study Report, supra*, at xxxii (emphasis supplied).

** *Id.* (emphasis supplied).

The difficulties inherent in attempting to articulate appropriate guidance on the extent to which the use of nonpublic market information should be subject to Rule 10b-5 has apparently been evident to the SEC even after its *Institutional Investor Study Report*. In 1973, the Commission noted both the need for and the lack of any concrete regulations in this area by requesting comments, among other things, on whether "securities [market] professionals" must disclose market information prior to trading while in possession of that information. *See* Securities Exchange Act Release No. 10316

(footnote continued on next page)

C. The Court of Appeals' Suggestion that its "Abstain-or-Disclose" Standard of Rule 10b-5 Liability Should Be Applied Automatically to All "Market Insiders" Is Overly-Broad.

The foregoing discussion is not intended to suggest that Section 10(b) and Rule 10b-5 are wholly inapplicable to market professionals who effect securities transactions while in posession of material, nonpublic, market information. One decision of this Court, as well as those of other courts, indicate that Rule 10b-5 may have a role to play in this context;* those cases, however, are rooted on significantly firmer and more precise ground than is the opinion of the court below.

For purposes of analyzing the decision below, it is not necessary to focus on the application of Rule 10b-5 to affirmative misstatements or half-truths about outside information. The court below was not confronted with such a situation, and Section 10(b) is, by its terms, applicable to all situations involving deception in connection with a securities transaction. Whether the defendant is a corporate insider or outsider, a market professional or not, and whether the information in issue emanates from within or without the corporation, false statements or half-truths made to induce

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(Aug. 1, 1973), 2 *SEC Docket* 229 (Aug. 14, 1973). Although such guidance was promised, as the court below has noted on another occasion "[t]he SEC itself has [now] despaired of providing written guidelines. . . ." *Securities and Exchange Commission* v. *Bausch & Lomb, Inc.*, 565 F.2d 8, 10 (C.A. 2, 1977) (Kaufman, C. J.).

* *See, e.g., Affiliated Ute Citizens of the State of Utah* v. *United States, supra,* 406 U.S. at 152-153. Although this Court's decision in *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* involved a species of outside, or market information, that action did not involve any allegation of a violation of Rule 10b-5. *See Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 471 n. 11.

(or in connection with) a securities transaction are doubtlessly actionable under Rule 10b-5.*

Here, a threshold difficulty is that this case involves neither affirmative misrepresentations nor half-truths but, rather, focuses upon the petitioner's failure to speak at all. Of course, even as to silence, the courts have long recognized that the failure to speak, *when there exists a duty to do so,* may be actionable under Rule 10b-5.** But, those cases have principally involved the conduct of traditional corporate insiders (or those who derive inside information from them, a class of persons as to whom the imputation of a duty to

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* *See, e.g., United States* v. *Charnay,* 537 F.2d 341 (C.A. 9), *certiorari denied,* 429 U.S. 1000 (1976); *Securities and Exchange Commission* v. *Dolnick,* 501 F.2d 1279 (C.A. 7, 1974); *Myzel* v. *Fields,* 386 F.2d 718 (C.A. 8), *certiorari denied,* 390 U.S. 951 (1968); *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (C.A. 5), *certiorari denied,* 365 U.S. 814 (1960); *In re Delafield & Delafield,* Securities Exchange Act Release No. 8480, [1967-1969 Decisions] CCH Fed. Sec. L. Rep. ¶77,648 (SEC, 1968); *In re Ward La France Truck Corp.,* 13 S.E.C. 373 (SEC, 1943); Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 802. *Cf.* Section 9(a)(4) of the Act, 15 U.S.C. §78i(a)(4).

** *See, e.g., Affiliated Ute Citizens of the State of Utah* v. *United States, supra,* 406 U.S. at 151-153; *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228 (C.A. 2, 1974); *Radiation Dynamics, Inc.* v. *Goldmutz,* 464 F.2d 876 (C.A. 2, 1972); *Chasins* v. *Smith, Barney & Co.,* 438 F.2d 1167 (C.A. 2, 1970); *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* 401 F.2d at 848-849; *Heit* v. *Weitzen,* 402 F.2d 909 (C.A. 2), *certiorari denied,* 395 U.S. 903 (1968); *Opper* v. *Hancock Securities Corp.,* 250 F. Supp. 668 (S.D. N.Y., 1966); *In re Faberge, Inc.,* Securities Exchange Act Release No. 10174, [1973 Decisions] CCH Fed. Sec. L. Rep. ¶79,378 (SEC, 1973); *In re Investors Management Co., supra,* CCH Fed. Sec. L. Rep. ¶78,163; American Bar Association Comment Letter, *supra,* at pp. D-6-D-7. *Cf. Zweig* v. *The Hearst Corp.,* [Current Decisions] CCH Fed. Sec. L. Rep. ¶96,851 (C.A. 9, 1979).

speak, and hence the applicability of Rule 10b-5, is surely appropriate.*

The court below sought to impose a similar duty on the petitioner, apparently on the theory that Section 10(b) and Rule 10b-5 were intended to assure that all participants in the securities marketplace have "equal access" to material information of any kind (Pet. App. A7). And yet, neither the language of Section 10(b) nor its meager legislative history suggests that *absolute* equality of access was a purpose of the legislation generally, or of Section 10(b) in particular. Indeed, the abstract application of such a principle to a wide variety of situations involving securities dealers that the court below never considered, but may have encompassed by its broad language, is not a result required by anything within the statute.

There is little doubt that Congress intended to insure "equal access" to basic operating facts about companies whose securities are publicly held and traded. That desire impelled the adoption of Sections 13(a) and 15(d) of the Securities Exchange Act, 15 U.S.C. §§78m(a) and 78*o*(d), which require such companies to file public reports with the SEC setting forth, on a periodic basis, the results of their

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* As we have seen, Rule 10b-5 was adopted specifically to enable the SEC to preclude corporate insiders from abusing inside information (*see* p. 23, *supra*). Moreover, the legislative history of the Securities Exchange Act unequivocally reflects Congress' desires to preclude corporate insiders from profiting at the expense of minority shareholders by using inside information as a basis for buying or selling securities. S. Rep. No. 792, *supra*, at 9-10; H. R. Rep, No. 1383, *supra*, at 13-14. *And see*, Sections 16(a) and 16(b) of the Securities Exchange Act, 15 U.S.C. §§78p(a) and 78p(b). It is, therefore, entirely consistent with the "'catchall'" role of Section 10(b) to impose a duty on corporate insiders to abstain from trading altogether, if they cannot disclose material, nonpublic, *inside* information before effecting transactions in the securities of their corporations.

operations.* And, as noted, Congress also sought to prevent certain, specified, persons—mainly corporate insiders—from taking advantage of their superior access to material corporate information.** But, neither those provisions nor any other provisions of the Act support the broader application of the principle of equal access to *all* forms of market information, as the court below suggested.

The application of the federal securities laws antifraud proscriptions to the nondisclosure of market information, therefore, must rest on a different basis from that suggested by the court below. Traditionally, nondisclosure has been deemed to constitute fraud only where some independent duty to speak exists.*** In fact, that has been the standard generally applied in the few "market information" cases brought under the federal securities laws antifraud provisions.**** In certain circumstances, Congress did identify the kind of relationship that properly may give rise to a duty to speak, such as the situation where an investment ad-

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* S. Rep. No. 792, *supra*, at 10-11; H. R. Rep. No. 1383, *supra*, at 11-13.

** *See, e.g.*, S. Rep. No. 792, *supra*, at 9-10; H. R. Rep. No. 1383, *supra*, at 13-14; Sections 16(a) and 16(b) of the Act.

*** Fleischer, Mundheim & Murphy, *supra*, 121 U. Pa. L. Rev. at 804-805. *See also* American Bar Association Comment Letter, *supra*, at pp. D-1-D-2.

**** In *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 197, for example, the Court concluded that an injunction may be issued "to require an [investment] adviser to make full and frank disclosure of his practice of trading on the effect of his [subsequent] recommendations." The decision focused on the reliance that is inherent in fiduciary relationships between an adviser and his client. "An investor seeking the advice of a registered investment adviser must . . . be permitted to evaluate . . . overlapping motivations, through appropriate disclosure, in deciding whether an adviser is servicing 'two masters' or only one, 'especially . . . if one of the masters happens to be economic

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viser overreaches its clients.* Where no such *statutory* relationship exists, however, this Court has suggested that Rule 10b-5 may be an inappropriate device by which to imply new federal fiduciary duties. *Santa Fe Indus., Inc.* v. *Green, supra,* 430 U.S. at 479-480 and n. 11.** At least with respect to securities dealers engaged in their normal trading activities, as a general proposition the existence and extent of their fiduciary relationships more appropriately should be governed by express regulations; in the absence of such express regulations, and except as discussed immediately below, the creation of fiduciary relationships by implication under Rule 10b-5 should be reserved for exceptional circumstances.

Alternatively, liability under Rule 10b-5 may be predicated upon the deliberate, and purely personal, utilization of market information, where the information was received solely by virtue of a confidential business relationship, and where there is a clear showing "that an expectation of fair dealing . . . is justified."*** This has been the basis for the imposition of liability in those cases involving a misuse of market information where no federal fiduciary relationship

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self-interest.' " *Id.*, at 196 (citation deleted). *See also, e.g., Courtland* v. *Walston & Co., Inc.*, 340 F. Supp. 1076 (S.D. N.Y., 1972); *Securities and Exchange Commission* v. *Alex N. Campbell*, Litigation Release No. 6567 (Oct. 30, 1974), 5 *SEC Docket* 383 (Nov. 12, 1974) (E.D. Pa.) (consent decree); *In re Kidder, Peabody & Co., Inc.*, 43 S.E.C. 911 (SEC, 1968). *Cf. Strong* v. *Repide*, 213 U.S. 419 (1909); *Zweig* v. *The Hearst Corp., supra,* CCH Fed. Sec. L. Rep. ¶96,851.

* *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra. And see,* Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. §80b-6.

** *Cf. Burks* v. *Lasker, supra,* 441 U.S. at ____, 99 S. Ct. at 1838-1840; *Touche Ross & Co.* v. *Redington, supra,* 442 U.S. at ____, 47 U.S.L.W. at 4734-4735.

*** Fleischer, Mundheim & Murphy, *supra,* 121 U. Pa. L. Rev. at 822.

exists.* Since market professionals appropriately may effect certain securities transactions while in possession of some types of undisclosed market information, however, the application of this standard of liability would accomplish the goals the court below sought to effectuate without up-

* *See, e.g., Zweig* v. *The Hearst Corp., supra,* CCH Fed. Sec. L. Rep. ¶96,851 (a financial columnist, who had received access to inside corporate information, utilized his newspaper column for the purpose of enhancing the profitability of his own securities trading activities; *cf.* Section 17(a) of the Securities Act, 15 U.S.C. §77q(a)); *Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (C.A. 2, 1973) (a majority shareholder used its access to inside corporate information to effectuate the company's reorganization without disclosing adequately its plans to liquidate the company); *Reed* v. *Riddle Airlines*, 266 F.2d 314 (C.A. 5, 1959) (a corporate insider purchased stock without disclosing his knowledge of a third party's interest in the company); *Securities and Exchange Commission* v. *Healey*, Litigation Release No. 6589 (Nov. 18, 1974), 5 *SEC Docket* 524 (Dec. 3, 1974) (S.D. N.Y.) (consent decree) (an employer of tender offeror utilized knowledge of target company to make a profit from trades in target company stock); *In re Blyth & Company, Inc.*, 43 S.E.C. 1037 (SEC, 1969) (a securities professional traded on the basis of information obtained illegally from a government agency); *In re George J. Wunsch*, 44 S.E.C. 95 (SEC, 1969) (a securities dealer effected securities transactions for his own personal enrichment on the basis of information relating to both its customers' and employer's securities holdings). *Cf. United States* v. *Peltz*, 433 F.2d 48 (C.A. 2, 1970), *certiorari denied*, 401 U.S. 955 (1971) (trading on the basis of nonpublic information about forthcoming SEC enforcement actions).

setting the proper regulatory balance the Congress sought to achieve in adopting the Securities Exchange Act.*

CONCLUSION

Congress and the SEC, as discussed above, have continued to remain sensitive and attentive during the past few years to the important functions performed by market professionals; both have made considered efforts to avoid limiting the participation of market professionals by adopting rules which artificially or unnecessarily restrict their ability to perform their normal, and customary, trading activities. In contrast, the court below has rendered an interpretation of Rule 10b-5 that could, indeed, artificially restrict the valuable functions performed by market professionals. To that extent, the decision below runs afoul of the Court's admonition just this Term that the federal courts are simply "not at liberty to legislate" a different result from the one Congress has ordained.*

For the foregoing reasons, therefore, the Association urges this Court not to endorse the test of Rule 10b-5 liability articulated by the court below.

Respectfully submitted,

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* In a number of cases, Rule 10b-5 liability has been asserted against market professionals who have abused market information obtained as a result of access to, or a relationship with, the issuer of the securities that were purchased or sold. *See, e.g., United States* v. *Re*, 336 F.2d 306 (C.A. 2), *certiorari denied*, 379 U.S. 904 (1964) (specialist who traded in one of its specialty stocks as part of a manipulation by the issuer of that stock); *In re Albert Fried & Co. and Albert Fried, Jr., supra* ("the specialist impliedly represents that he will not take advantage of his unique position and his customers' ignorance of market conditions nor exploit that ignorance to extract unreasonable profits"); *Fridrich* v. *Bradford*, 542 F.2d 307 (C.A. 6, 1976), *certiorari denied*, 429 U.S. 1053 (1977) (over-the-counter market makers may not trade on the basis of inside information obtained through access to the issuer); *cf. Schonholtz* v. *American Stock Exchange, Inc.*, 505 F.2d 699 (C.A. 2, 1974); *Securities and Exchange Commission* v. *Resch-Cassin & Co., Inc.*, 362 F. Supp. 964 (S.D. N.Y., 1973); and *Securities and Exchange Commission* v. *Stern-Haskill, Inc.*, [1978 Decisions] CCH Fed. Sec. L. Rep. ¶94,065 (S.D. N.Y., 1973).

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* *Touche Ross & Co.* v. *Redington, supra*, 442 U.S. at ——, 47 U.S.L.W. at 4737.